APPENDIX A

No. 16243

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

FREDERICK STEEL CO., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On petition for review of the decision of the Tax Court of the United States

Amended opinion, filed April 28, 1967.

Before: O'SULLIVAN and PHILLIPS, Circuit Judges, and MCALLISTER, Senior Circuit Judge.

MCALLISTER, Senior Circuit Judge. Under Internal Revenue statutes, the question whether losses incurred in prior years by a corporation may be used as carry-overs against income realized from an entirely different enterprise that was later transferred to the corporation, has, in the past, led to confusing and contradictory decisions by the Commissioner of Internal Revenue, and by the courts.

Congress, in its effort to remedy this situation, sought, in 1954, a new fully integrated revenue code. Both House and Senate Committees having the legislation for consideration reported, at that time, that "Present practice rests on *court-made law which is*

uncertain and frequently contradictory. Moreover, whether or not the carry-over is allowed should be based on economic realities rather than upon such artificialities as the legal form of reorganization." (Emphasis supplied.) U.S. Cong. and Adm. News, 1954, Vol. 3, 4066 (House Report), p. 4683 (Senate Report).

Accordingly, after years of research, Congress adopted such a code in the Internal Revenue Code of 1954.

We are here concerned with the Internal Revenue Code of 1954 and the provisions thereof governing allowance of loss carry-overs.

The issue in this case is whether losses incurred by a corporation in the beer and ice business, which was discontinued in 1952, as well as losses incurred in carrying idle real estate previously used in those businesses, may be used as carry-overs for purposes of deductions in 1954 and later years, against income realized from an entirely different enterprise that was transferred to the corporation in 1954. Petitioning taxpayer contends that such losses may be used as carry-overs for purposes of deductions. The Commissioner of Internal Revenue denied such contention, and assessed deficiencies for the years 1954, 1955, 1956, and 1957, and the Tax Court upheld the main contentions of the Commissioner.

One section of the Internal Revenue Code of 1939, and four sections of the Internal Revenue Code of 1954 are here in question: Sec. 122 of the Revenue Act of 1939 (26 U.S.C. 1952 ed., Sec. 23); Sec. 172 of the Revenue Act of 1954 (26 U.S.C. 1958 ed., Sec. 172); Sec. 269 of the Revenue Act of 1954 (26 U.S.C. 1958 ed., Sec. 269); Sec. 381 of the Revenue Act of 1954 (26 U.S.C. 1958 ed., Sec. 381); and Sec. 382 of the Revenue Act of 1954 (26 U.S.C. 1958 ed., Sec. 382).

We shall discuss these various sections, in what we deem the appropriate order, regardless of the time of their enactment.

Section 269 deals with acquisitions of corporate control made to evade or avoid income tax. This section has been disposed of, contrary to the Commissioner's contention, by the findings of the Tax Court that there was a genuine business purpose in acquiring corporate control, and that such acquisition of control was not carried out in order to take advantage of the losses in question, but rather for the purpose of making a substantial profit on the transaction, which, however, "contrary to expectations, did not materialize." There is substantial evidence to sustain the finding of the Tax Court that the acquisition of control was not carried out to evade or avoid income tax, and, certainly the findings were not clearly erroneous.

However, the Tax Court held that the deductions claimed by the Taxpayer must be disallowed "on the other ground" which, from the recital in the opinion of the Tax Court, appears to mean that the deductions must be disallowed on the ground that the losses in question may not be used as carry-overs, under Section 122 of the Internal Revenue Code of 1939, since it supports its view by a discussion of, and reliance on, the case of *Libson Shops, Inc.* v. *Koehler,* 353 U.S. 382, which, as the Government contends in the instant case, "was decided under the statutory language of Section 122 of the 1939 Code."[1]

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[1] SEC. 122 [as added by Section 211(b), Revenue Act of 1939] NET OPERATING LOSS DEDUCTION.

(a) [as amended by Section 105(e)(3)(A), Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Net Operating Loss.*— As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the

The reason, then, that the Tax Court disallowed the deductions sought by petitioning taxpayer was on grounds other than Section 269 of the Revenue Code of 1954, and those grounds were stated as follows: "The *Libson Shops* case [*supra*] and a number of decisions following it in a wide variety of situations have spelled out a requirement of continuity of business enterprise—that losses growing out of one business may not be carried forward to be applied in later years against income derived from an entirely different business. The Court in *Libson Shops* noted that the statutory provisions were enacted so as to allow a business to avoid the harsh consequences of taxing income on an annual basis; '. . . [they were] designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year.'" 42 T.C. 13, 21.

Having thus outlined the law considered to be applicable, the Tax Court applied it to the facts in this case in the following manner:

> "The tax years before us are 1954–1957, and the only operating income realized by petitioner

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gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) [as amended by Sec. 153(a), Revenue Act of 1942, *supra*, and Sec. 215(a), Revenue Act of 1950, c. 994, 64 Stat. 906]

* * * * *

(2) Net operating loss carry-over.—

* * * * *

(B) *Loss for Taxable Year Beginning After* 1949.—If for any taxable year beginning after December 31, 1949, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the five succeeding taxable years, except that the carry-over in the case of each such succeeding taxable year (other than the first succeeding taxable year) shall be the excess, if any, of the amount of such net operating loss over the sum of the net income for each of the intervening years computed—

during those years was derived from its business as a finished steel jobber, a business which petitioner acquired in 1954 and which was entirely unrelated to the beer and ice business. The only other income of petitioner during the period 1954–1957 was the $201,055.74 profit upon its sale of the former Donal assets in 1954; these assets related to an electrical tool business theretofore carried on by another corporation and had no connection whatever with the beer and ice business. The rationale of the foregoing decisions requires us to hold that the pre-1954 losses which grew out of an entirely different enterprise may not be carried over in computing net operating loss deductions in the circumstances before us." 42 T.C. 13, 22.

Obviously, then, the Tax Court decided the case under the so-called "Continuity of Business Enterprise Doctrine," as delineated by the Supreme Court in *Libson Shops, Inc.* v. *Koehler, supra,* and other cases mentioned in the Tax Court's opinion, and in accordance with Section 122 of the 1939 Code.

Petitioner taxpayer contends that the Internal Revenue Code of 1954 changed the 1939 Code, and the applicable law; that the 1954 Code applies in this case; and that *Libson Shops, Inc.,* decided under the 1939 Code, *does not now apply,* with its "Continuity of Business Enterprise Doctrine," to this case.

With regard to the foregoing contention of petitioner taxpayer, we are here concerned with Section 122 of the 1939 Internal Revenue Act, and Section 172 of the 1954 Code.

Section 122 of the 1939 Code is the predecessor of Section 172 of the 1954 Code which creates the carryover deductions; but the latter section and accompanying sections of the 1954 Code constitute a substantial revision of Section 122 of the 1939 Code. In commenting on the change wrought by Section 172 of the 1954 Code, it was said in *Maxwell Hardware Com-*

pany v. *Commissioner,* 343 F. 2d 713, 718 (C.A. 9) that "it was the clearly expressed intention of Congress to attempt to bring some order out of chaos, and, in effect, to countenance 'trafficking' in operating loss carry-overs except as affected by the special limitations of Section 382 and the general limitations of Section 381" of the 1954 Code.

Returning to a summary of the statutory provisions before us, Section 122 of the 1939 Code provides that if the *taxpayer* has a net operating loss, it shall be a net operating loss carry-over.

Section 172 of the 1954 Code provides that a net operating loss shall be a net operating loss carry-over—without mention of the *taxpayer's* having sustained such a loss. In *Maxwell Hardware,* the court held that, under Section 172, the corporation (which was the taxpayer) was entitled to utilize the loss carry-over, *even though it was not the same business enterprise that had sustained the loss.*

Section 381 of the 1954 Code provides for the survival of net operating loss carry-overs from one corporation to its successor, when their assets are combined in a tax-free reorganization, or merger (Section 368). In this case it does not matter that the bundle of assets which produced the losses did not contribute to the subsequent profits. Section 381 does not affect the right of petitioner, in this case, to claim the net loss carry-over in question, but, on the contrary, provides that such carry-over survives.

Section 382 of the 1954 Code, insofar as here applicable, provides for disallowance of net operating loss carry-overs when two factors occur—when there has been both a 50% change in value of stock ownership, and a change in the nature of the business.

Both factors—change of nature of the business and change in ownership—are determined at the close of

the taxable year for which benefit of the deduction is sought; and the *change of ownership* is measured by comparison with the beginning of that taxable year or the prior taxable year, or (by virtue of Section 394(b) of the 1954 Code) June 22, 1954, whichever occurs later; and the *change of business,* by comparison with the business carried on prior to the change of ownership.

In the instant case there was, then, a change in the nature of the business; but the second factor is lacking—a change in the ownership of the business within the period specified in the statute.[2] Accordingly, under the provisions of Section 382, the net operating loss carry-over is not here to be disallowed to petitioner.

In answer to certain contentions of the Commissioner, it is to be observed that Section 382(a) is effective as to taxable years ending after June 22, 1954. See Section 7851(a)(1)(C) and Section 395(a) of the Code of 1954. We are here concerned with taxable years ending December 31, 1954, and subsequent years. Section 382 is, therefore, applicable to the taxable years here in question.

The *amount* of the net operating losses giving rise to the carry-overs here involved is to be determined under the 1939 Code, since whether a net operating loss occurs depends upon the law of the year of the purported loss; but the *allowance of the operating loss deduction* is governed by the year for which it is claimed.

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[2] We emphasize that our decision here does not conflict with what we have said in *Fawick Corporation* v. *C.I.R.*, 342 F. 2d 823 (C.A. 6, 1965) and *Euclid-Tennessee, Inc.* v. *C.I.R.*, 352 F. 2d 991 (C.A. 6, 1965), both announced after the Tax Court decision which we here review. In each of these cases, the change in ownership occurred at such time as to call for the operation of § 382(a)(1)(C). Such is not the situation here.

As to any rule against raising new issues on appeal, we are of the view that the merits of petitioner's contention should be passed upon.

> "The issue raised is purely one of law requiring no new or amplified factual determination. The question is simply the proper interpretation and application of the statute to determine the taxes due. The fact that the issue was not raised in the petition to the Board is immaterial and, under the circumstances here present, we have jurisdiction of the issue." *Black Motor Co.* v. *Commissioner,* 125 F. 2d 977, 980 (C.C.A. 6).

Other contentions made on this appeal are unnecessary to consider in our determination.

In accordance with the foregoing, the decision of the Tax Court that petitioner was not entitled to deduct in the years 1954–1957, net operating losses incurred in the years 1950–1953, is reversed, and the case is remanded for entry of decision consonant with this opinion.

UNITED STATES COURT OF APPEALS

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No. 16,243

FREDERICK STEEL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Before: O'SULLIVAN and PHILLIPS, Circuit Judges, and MCALLISTER, Senior Circuit Judge.

On Petition to Review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On Consideration Whereof, It is now here ordered and adjudged by this Court that the decision of the said Tax Court in this cause be and the same is hereby reversed and the case remanded for further proceedings consistent with the opinion.

No costs awarded. Rule 23(4).

Entered by order of the Court.

CARL W. REUSS,
Clerk.

APPENDIX B

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(s) [As added by Sec. 211, Revenue Act of 1939, c. 247, 53 Stat. 862, 867] *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

[26 U.S.C. 23 (1952 ed.)]

SEC. 122 [As added by Sec. 211, Revenue Act of 1939, *supra*]. NET OPERATING LOSS DEDUCTION.

(a) [As amended by Sec. 105, Revenue Act of 1942, c. 619, 56 Stat. 798, 807] *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

* * * * *

(b) [As amended by Sec. 215, Revenue Act of 1950, c. 994, 64 Stat. 906, 937–938] *Amount of Carry-Back and Carry-Over.*—

* * * * *

(2) *Net operating loss carry-over.*—

* * * * *

(B) Loss for Taxable Year Beginning After 1949.—If for any taxable year beginning after December 31, 1949, the taxpayer has a net operating loss, such net

operating loss shall be a net operating loss carry-over for each of the five succeeding taxable years, except that the carry-over in the case of each such succeeding taxable year (other than the first succeeding taxable year) shall be the excess, if any, of the amount of such net operating loss over the sum of the net income for each of the intervening years computed—

(i) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and

(ii) by determining the net operating loss deduction for each intervening taxable year, without regard to such net operating loss or to the net operating loss for any succeeding taxable year and without regard to any reduction specified in subsection (c).

For the purpose of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1949, shall be reduced by the amount, if any, of the net income for the preceding taxable year computed—

(i) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and

(ii) by determining the net operating loss deduction for such preceding taxable year without regard to such net operating loss and without regard to any reduction specified in subsection (c).

* * * * *

[26 U.S.C. 122 (1952 ed.)]

Internal Revenue Code of 1954:

SEC. 172. NET OPERATING LOSS DEDUCTION.

(a) *Deduction Allowed.*—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus

(2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

* * * * *

(g) *Special Transitional Rules.*—

(1) *Losses for taxable years ending before January 1, 1954.*—For purposes of this section, the determination of the taxable years ending after December 31, 1953, to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939.

* * * * *

[26 U.S.C. 172.]

SEC. 381. CARRYOVER IN CERTAIN CORPORATE ACQUISITIONS.

(a) *General Rule.*—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334 (b)(2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or trans-

feror corporation, subject to the conditions and limitations specified in subsections (b) and (c).

* * * * *

(c) *Items of the Distributor or Transferor Corporation.*—The items referred to in subsection (a) are:

(1) *Net operating loss carryovers.*—The net operating loss carryovers determined under section 172, subject to the following conditions and limitations:

* * * * *

[26 U.S.C. 381.]

SEC. 382. SPECIAL LIMITATIONS ON NET OPERATING LOSS CARRYOVERS.

(a) *Purchase of a Corporation and Change in Its Trade or Business.*—

(1) *In General.*—If, at the end of a taxable year of a corporation—

(A) any one or more of those persons described in paragraph (2) own a percentage of the total fair market value of the outstanding stock of such corporation which is at least 50 percentage points more than such person or persons owned at—

(i) the beginning of such taxable year, or

(ii) the beginning of the prior taxable year,

(B) the increase in percentage points at the end of such taxable year is attributable to—

(i) a purchase by such person or persons of such stock, the stock of another corporation owning stock in such corporation, or an interest in a partnership or trust owning stock in such corporation, or

(ii) a decrease in the amount of such stock outstanding or the amount of stock outstanding of another corporation owning stock in such corporation, except a

decrease resulting from a redemption to pay death taxes to which section 303 applies, and

(C) such corporation has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of the fair market value of such stock,

the net operating loss carryovers, if any, from prior taxable years of such corporation to such taxable year and subsequent taxable years shall not be included in the net operating loss deduction for such taxable year and subsequent taxable years.

* * * * *

(b) *Change of Ownership as the Result of a Reorganization.*—

(1) *In general.*—If, in the case of a reorganization specified in paragraph (2) of section 381(a), the transferor corporation or the acquiring corporation—

(A) has a net operating loss which is a net operating loss carryover to the first taxable year of the acquiring corporation ending after the date of transfer, and

(B) the stockholders (immediately before the reorganization) of such corporation (hereinafter in this subsection referred to as the "loss corporation"), as the result of owning stock of the loss corporation, own (immediately after the reorganization) less than 20 percent of the fair market value of the outstanding stock of the acquiring corporation,

the total net operating loss carryover from prior taxable years of the loss corporation to the first taxable year of the acquiring corporation ending after the date of transfer shall be reduced by the percentage determined under paragraph (2).

[26 U.S.C. 382.]

SEC. 393. EFFECTIVE DATES OF PARTS III AND IV.

* * * * *

(b) *Special Rules for Plans of Reorganization.*—

(1) *In general.*—Except as provided in paragraphs (2) and (3), parts III and IV shall apply only in respect of plans of reorganization adopted on or after June 22, 1954. For purposes of this paragraph and paragraphs (2) and (3), a plan to make a transfer to a controlled corporation described in section 351, or a plan to make an exchange or distribution which is described in section 355 (or so much of section 356 as relates to section 355) shall be treated as a plan of reorganization.

* * * * *

[26 U.S.C. 393.]

SEC. 394. EFFECTIVE DATE OF PART V.

(a) *Section 381.*—Except as otherwise provided in this subchapter, section 381 shall apply to liquidations and reorganizations, the tax treatment of which is determined under this Code.

(b) *Section 382 (a).*—For purposes of applying the special limitation on net operating loss carryovers in section 382(a), the beginning of the taxable years specified in clauses (i) and (ii) of section 382(a)(1)(A) shall be considered to be the beginning of such taxable years or June 22, 1954, whichever occurs later.

(c) *Section 382(b).*—Section 382(b) shall apply to reorganizations, the tax treatment of which is determined under this Code.

[26 U.S.C. 394.]

SEC. 395. SPECIAL RULES FOR APPLICATION OF THIS SUBCHAPTER.

* * * * *

(b) *Repeal and Continuance of Internal Revenue Code of 1939.*—To the extent that the provisions of this subchapter supersede the provisions of the Internal Revenue Code of 1939, such provisions of the Internal Revenue Code of 1939 are hereby repealed. The provisions of the Internal Revenue Code of 1939 shall continue to apply with respect to transactions for which rules are provided in this subchapter until such rules take effect.
[26 U.S.C. 395.]

SEC. 7851. APPLICABILITY OF REVENUE LAWS.

(a) *General Rules.*—Except as otherwise provided in any section of this title—

(1) *Subtitle A.*—

* * * * *

(C) Any provision of subtitle A of this title the applicability of which is stated in terms of a specific date (occurring after December 31, 1953), or in terms of taxable years ending after a specific date (occurring after December 31, 1953), shall apply to taxable years ending after such specific date. Each such provision shall, in the case of a taxable year subject to the Internal Revenue Code of 1939, be deemed to be included in the Internal Revenue Code of 1939, but shall be applicable only to taxable years ending after such specific date. The provisions of the Internal Revenue Code of 1939 superseded by provisions of subtitle A of this title the applicability of which is stated in terms of a specific date (occurring after December 31, 1953) shall be deemed to be included in subtitle A of this title, but shall be applicable only to the period prior to the taking effect of the corresponding provision of subtitle A.

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[26 U.S.C. 7851.]

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